Caron’s Corner Transcript – 2.6.2023

The Soft-Landing Super Bowl: Here’s Our Playbook

- If we can make the analogy between economic data releases competing to create the narrative of the market and a football game, then last week was the Super Bowl.

- The winner? The side that supported a soft landing. In fact, Fed Chairman Jerome Powell delivered that message as such in his presser last Wednesday.

- **Now what?** The consensus is pushing the previous expectation for a softening of market prices from the first half of 2023 into the second half. This was the big change based on last week’s data.

- In simple terms, we’ve gone from a ‘‘dip, then rip” scenario to “rip, then dip” for market prices. Importantly, the consensus is not ceding an economic and market swoon at least at some point this year.

- We’ve been consistent about where we stand on this, believing investors are holding too much cash, essentially underinvested and vulnerable to a market rally. This provides a technical advantage for the market to overemphasize positive economic data and push prices higher.

- As we’ve said before, “risk-on” is a risk, and like any other risk needs to be hedged. The market is now vulnerable to chase prices higher.

- But it’s not just about the technicals. Fundamentals matter too. Last week’s economic data was a turning point for many to change their outlook.

- Remember too though that correlations across asset classes remain high, a risk that need to be addressed. As we like to say it’s better to be balanced than defensive, and portfolio construction is the key.

Jim Caron: Hello everyone. This is Jim Caron Co-CIO of the Global Balance Strategies at Morgan Stanley Investment Management. Coming up this Sunday is the Super Bowl and I'm going to try to do this Caron’s Corner with a Super Bowl theme. The audiocast is called The Soft-Landing Super Bowl: Here's Or Playbook. If we can make an analogy between economic data releases competing to win the narrative of the market and a football game, then last week was the Super Bowl, and the side that supported the soft landing won. Furthermore, Fed Chairman Powell delivered a message that was very consistent with that last Wednesday. So what's next?

Well, the consensus is now pushing the previous expectation for a soft landing of market prices from the first half of 2023 into the second half, the big change as a result of last week's data. Said in simple terms, we've gone from a “dip, then rip” scenario to “rip, then dip” for market prices. But importantly the consensus is not giving up on an economic and market swoon, at least at some point later this year. Now, you know where we stand on this, we've been outspoken about it. We think people are holding too much cash and are underinvested or vulnerable to a market rally, and this provides a technical advantage for the market to overemphasize positive economic data and push prices higher. As we've said before, risk-on is a risk like any other risk and needs to be hedged. The market is now vulnerable to chase prices higher. But it's not just about technicals. Fundamentals matter too. Last week's economic data was actually a turning point for many to change their tune. So let's get into it.

Last week's matchup was the soft landing narrative versus the hard landing narrative. And again, spoiler alert, the soft landing won. Now let's go to the highlight reel of what took place last week. For context, we're going to start with the Employment Cost Index, what we call the ECI, and this is a quarterly measure of employee cost per unit output. It came in about a 10th of a percent below expectations at 1% and has actually fallen, down from 5.1% a year ago. I guess we could consider this a early in the week win for those looking for cooling and economic index in the dovish Fed, but really that was it for the week. There was really nothing more on the dovish side. After that came an onslaught of stronger data. The JOLTS report (Job Openings and Labor Turnover Survey) showed 11 million job openings and that's up 600,000 from last time, which is a surprise to the upside and going the wrong way for those looking for weakness. It's the highest it's been since July of 2022. The vacancy to unemployment ratio, a favorite ratio I look at, actually rose to 1.9 to 1. This represents the number of jobs open for every unemployed person, meaning there are almost 2 job openings for everyone looking for a job. In fact, this measure peaked at 2 to 1 in March of last year, meaning the labor market remains tight. There are no signs of making progress to loosen the jobs in almost a year.

Now let's look at unit labor costs. This is another measure of employment costs and something that Powell looks at quite a bit as well. Now, unit labor costs represent how much a business pays its worker for unit of output, but the pay is broadly measured, not just in terms of salary directly, but it also includes things like benefits and health care. It's a total cost measure and it came in slightly lower than expected. So maybe at face value this was a win for those looking for disinflation, but when you dig into it, not really, because essentially the strong wage pressures pushed compensation per hour up 4.1% annualized in the fourth quarter. That's a pretty big rise, in fact the fastest pace in a year. But accounting for the stronger productivity increase actually translated into a more muted 1.1% rise in unit labor costs. We have to dissect this. In essence, there was there was a 3.5% annualized rise in output which is going to lead to productivity which outpaced the muted 0.5% increase in hours work. This resulted in a strong 3% rise in non-farm productivity. You can hear people talking about productivity went up and you know, isn't that such a good thing? Well, context matters. So while the rise of productivity in the fourth quarter was solid, the numbers are highly volatile and quarter-end productivity was actually 1.5% lower than a year ago, which extends a decline in productivity, a trend in productivity not seen since the early 1980s. Again, productivity was high over the last quarter's measure, but if we look at the trend, it is still going down and this really still keeps labor markets tight and supportive of high wage inflation. The punch line is, the less productive company is, the more it has to pay for labor.

Now let's turn to the jobs report. Now a lot has been said about this, but we added 517,000 jobs versus 188,000 expected, and if that weren't enough, the unemployment rate fell to 3.4%, the lowest it's been since 1969. Back-month revisions are important to look at an were up 813,000 for 2022. What this means is that the labor market is a lot tighter than anyone had previously thought and that's the theme that we want to carry through all of the data that we saw last week, including the Fed statement. We can blame some of that on seasonal factors, but the overarching message is that the labor market is still very tight, tighter than anybody had thought previously. That was the big revelation from last week.

Now let's start to think ahead and think about what the playbook for the markets might be in terms of investing and how we're thinking about investing. We have to go back to the Fed. Let it not be lost on anyone that the Fed's base case is now firmly footed in the soft landing camp. The significance of this is that while they're still concerned about inflation, they realize it's actually heading lower and therefore they're not as worried about it as they were before. What this means is that they're willing to allow financial conditions to get easier, which means higher asset prices without feeling the need to push back against it as much as they did before. Perhaps Powell and others at the Fed do not walk back some of the dovish comments made at last week's presser. Of course, though, they will always say that inflation is a concern. Now this is a nuance, but it's very important because essentially it seems like the Fed is taking a different footing on how they see financial conditions and their concerns over inflation, which seem to be lessening because they believe inflation is coming down. In fact maybe they allow asset prices to go up and they don't push back as hard. This is a key point and unemployment is much stronger than previously thought, but that also means the consumer and consumer credit is stronger too.

Let's go down the list and think about where we can think about investing and what might have some opportunities and advantages. So let's look at asset-backed securities like credit cards, auto loans and things of that nature. While weakening may not get as weak as many fear, given the strength in the labor market, and given that people are still earning incomes because jobs are still there and they're earning a salary, this then extends to demand for housing and housing related credit concerns. We still think that housing bottoms in the second quarter, broadly positive for housing assets, bonds and equities alike, but probably more so for equities, given how beaten down the sector was on expectations for a deeper recession. Turning to high yield assets and credit, if the consumer is stronger than so is consumption, which feeds into sales and earnings default risks, and although they may rise less than many have thought previously, this explains the recent narrowing of credit spreads. All-in yields still remain attractive. Even though spreads have started to tighten, all-in yield levels still make this asset class reasonably attractive given that we believe the Fed might be done in the next couple of months with rate hikes and we might enter into a stable rate environment where all-in yield starts to matter to investors

Emerging markets. If the Fed has only “a couple of more hikes,” Powell's quote, then interest rate differentials, which drive currencies between say the Fed and the ECB, Bank of England or other global central banks, may favor or even argue for a weaker dollar that puts a stable or weaker dollar into the camp of easing global financial conditions and this would essentially support world growth. More stable, possibly a weaker dollar is a good thing for world growth, and obviously emerging markets could take advantage of that.

Turning to commodities, commodity factors seem undervalued for a potential rebound in our opinion or less slowing than previously thought economic activity might be. Another way to say it remains an underinvested and under supplied asset class and supportive of higher prices and a hedge to inflation risks as well. This is an interesting asset class to have in one's portfolio as well as a potential value opportunity as an investment, but also as a hedge against inflation, you know, rising at some point.

Now obviously all of this now goes to equity, so equities, this is a positive for equities. Topline revenue growth or corporate income remain likely to be strong. Yes, earnings and profit margins, revenues minus expenses, may be coming under pressure, but investors may be willing to pay higher multiples for future growth if they believe today's decline in earnings is just a correction. Again, this is nuanced, but I think it's important if people see the correction in earnings right now as a correction that even though earnings are coming down as part of this correction, people, maybe investors may be willing to pay a higher evaluation or multiple for those future cash flows if they believe that we get better growth down the road. That might be something that's keeping equity prices buoyant and might continue to do so. Now when we think about equities, we also have to address the growth sectors of the markets. We all know how beaten down that was last year. Well this year growth is making a big comeback and it may have even more ground to make up. While our longer term views still favor the value sector of the market, we cannot ignore how beaten down the growth sector has become. It is staging a comeback as I mentioned previously, but we like to look at sectors within growth that have pricing power.

Now risks still exist. I don't want anybody to ignore this. This is not merely a goldilocks scenario, there are still risks. Our top risk remains that inflation falls in the first half of the year but seems to become unanchored in the second half, and if this occurs then it brings the Fed in for a second round of rate hikes which will be negative for assets and asset prices broadly. We still have a sense of risk that yes, a decline in the first half of the year in terms of inflation, but if we see that it doesn't go down far enough or it looks like it's becoming unanchored and may start to bubble up again, I think that brings all central banks back to the table and hiking rates. Clearly markets are not priced for this if you look at the forward interest rate curve. This would be a surprise.

So the investment strategy that we're advocating is being active, being nimble and more importantly, being balanced in terms of your risks. We want to participate in the positive performance of market prices but we remain wary of the risks and will look for signs of unanchored inflation to change our views and portfolio exposures. Again, this is something maybe coming in the next few months ahead, not for right now. We advocate balanced investment strategies to balance market risks in portfolios.

Understand that correlations across asset classes remain high. I can't emphasize that enough. This is a big risk, that correlations across asset classes still remain very high, which will make diversification a challenge. From this perspective, 2023 is still just as risky as 2022 because these correlations are high. Unfortunately if asset prices are going up, people tend to ignore high correlations, but when asset prices go down, they really, they really tend to pay attention to this high correlation risk. The fact of the matter is that - as we like to say - it's better to be balanced than to be defensive and portfolio construction in 2023 will be of paramount importance as to how one interprets the risk and, builds a portfolio.

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CRC 5448647 Exp. 2/29/2024